

The PERAC Financial Bulletin

Financial Market Review, First Quarter 2008



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“WORST FINANCIAL CRISIS IN A GENERATION”



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Amid great market volatility and increased fears of an economic recession, stocks declined across the board during the first quarter, with most broad market indices falling nearly 10%. After a five-year bull market, it is not surprising that the stock market is having a major correction this year but it was certainly not widely anticipated that the US would now be in the throes of the worst financial crisis in a generation.

During March, the Federal Reserve took a number of unusual precedent-setting steps aimed at shoring up the increasingly paralyzed financial system. The central bank extended credit to Wall Street brokerage firms for the first time and it brokered a bailout of one of the Street's leading firms, assuming the financial risk if the \$29 billion

in mortgage-related securities it assumed from Bear Stearns were to decline further in value. In its sixth cut over the past six months, the Fed slashed the Federal Funds rate by another three quarters of a point to 2.25% on March 18 in a further dramatic step aimed at restoring confidence in the economy and in the financial markets. In another major move, the government announced on March 19 that it was relaxing the capital requirement constraints on Fannie Mae and Freddie Mac so that these government-sponsored mortgage finance agencies could provide more liquidity to the struggling mortgage market.

As The Wall Street Journal noted in a March 27 article entitled "Ten Days That Changed Capitalism", this period "will be remembered

as the time the US government discarded a half-century of rules to save American financial capitalism from collapse."

The demise of Bear Stearns was swift and sudden. Similar to a bank that suffered a run due to a lack of confidence by depositors, the brokerage firm essentially suffered a run by the several different types of entities with whom it did business — investors, banks, other broker-dealers, hedge funds, etc. These lenders and clients had become increasingly concerned about Bear's significant holdings of troubled, difficult-to-trade securities, including risky mortgages. This loss of confidence led these counterparties to withdraw funds and to reduce their financial relationships with Bear Stearns, bringing about an alarming decline in the firm's capital base.

Chart 1

S&P 500, Six Months: Down and Dirty

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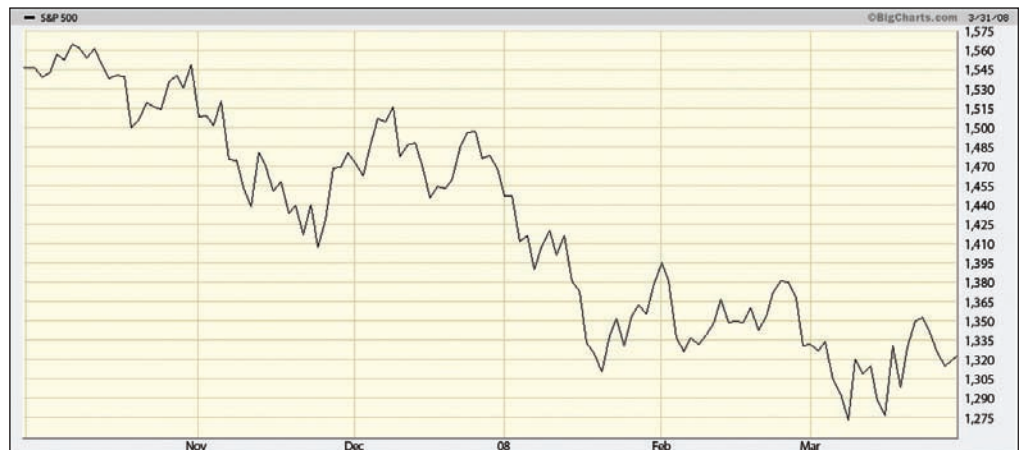


Chart 2

S&P 500, Five Years: After Five Years, Giving Back Some of the Gains

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From the Fed's point of view, it was not that Bear Stearns was too big to fail but that it was so interconnected to other financial entities that a sudden collapse would wreak havoc with the financial system. Thus, the Fed worked aggressively over a weekend to broker the firm's sale to JP Morgan Chase. For a stock that had been trading as high as \$160 a year ago and \$65 just days before the forced sale, the initial share price of \$2 set for the sale was shockingly low. It was revised to \$10 later in the month. In a general sense, the crux of the current turmoil is another example of markets going to extremes. Money became extraordinarily cheap and plentiful earlier this decade. With housing prices constantly rising, mortgage lenders relaxed their requirements to almost nonexistent standards.

Now that the tables have turned as home prices are declining and delinquencies rising, financial institutions of all types have become unusually reluctant to lend money. The downgrades and other problems related to bond insurers is another of the myriad other reasons leading to a loss of market access even for heretofore high grade borrowers. The unusually wide yield spread between LIBOR, the rate at which major banks make short-term unsecured loans to each other, and the Federal Funds rate is reflective of the unusually tight conditions in the worldwide credit markets. A massive amount of de-leveraging by hedge funds and other investors has added to the crunch in the credit markets and the volatility of the stock market. During the easy money period, financial

engineers created complex securities that were difficult for investors to understand, difficult for the rating agencies to rate, and difficult for the market to value; these fallen instruments account for much of the losses of up to \$400 billion expected to be ultimately absorbed by financial institutions.

Although the economic seers do not yet have sufficient data to officially term the slowdown a recession, it is clear that the persistent weakness in the housing market, the continued freeze in lending, as well as the alarming fall in the stock market were causing a decline both in consumer spending and in business capital investment. By one measure, consumer confidence has fallen to its lowest level since 1973. At the same time, the falling dollar, rising gold and commodity prices,

Chart 3

S&P 500, Ten Years: Back to Early 2001 Level

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Chart 4

S&P 500 vs. Russell 2000: Over Five Years, Small Caps Have Ruled

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and record-high oil prices were keeping inflationary risks intact, complicating the choices available to the Fed.

EQUITY MARKET

As economic worries grew, the US stock market suffered sizeable losses during the first days of the new year and never recovered. Even after a 4% bounce from its low just before the Bear Stearns collapse, the S&P 500 (large cap) Index, which is heavily weighted in financial stocks, was off 9.9% for the quarter (-9.45% including dividends). The Index's string of five consecutive monthly losses was its longest losing streak since the second half of 1990. At quarter-end, the Index was down 16% from its record high of last October. The NASDAQ Composite, which had outperformed the S&P in 2007, lost 14.1% during the quarter and is off 20% from its recent October high. The Russell 2000 Index of small com-

pany stocks, which are seen as most vulnerable to a recession, is down 9.9% for the year and 20% from its high. Both the Dow Jones Wilshire 5000 broad market index and the Russell 3000 Broad-Market Index lost 9.5% for the quarter. Overall, it was the worst quarter for stocks since the third quarter of 2002.

Amid its losses, the stock market experienced higher volatility than at any time since the Great Depression. The S&P 500 moved more than 1% on 51% of its trading days during the quarter, the biggest percentage since 1934. On April 1, the first trading day of the second quarter, the S&P 500 surged a remarkable 3.6% on hopes that the worst of the credit crunch was behind us.

All of the S&P 500's ten industrial sectors suffered first quarter losses, with Information Technology

(-15.4%), Financials (-14.7%), and Telecommunications Services (-14.6%) the worst and Consumer Staples (-2.8%), Materials (-3.6%), and Industrials (-4.5%) the least affected. Among the Dow Jones 30 Industrials, Wal-Mart (+10.8%), Caterpillar (+7.9%), and IBM (+6.5%) were among the five stocks that gained while Merck (-34.7%), Citigroup (-27.2%), and AIG (-25.8%) were the worst of the 25 losing stocks.

As noted above, large caps slightly outperformed small caps during the quarter. Given the slowdown in economic growth and lower expectations for corporate profits, the one year winning streak of growth over value was interrupted as value held up somewhat better during the quarter although it trailed growth significantly over the trailing twelve months.

Chart 5

10-Year Treasury Note Yield: Over the Past Year, a Significant Decline

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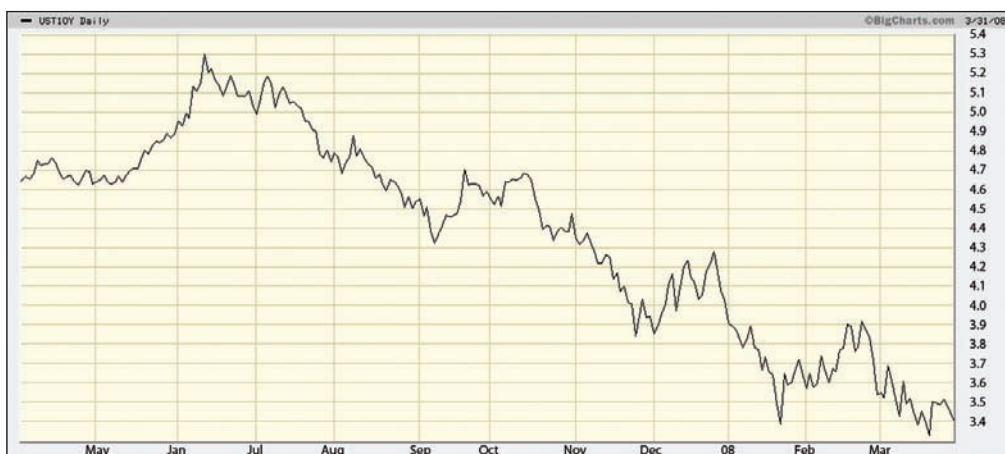


Chart 6

10-Year Treasury Note Yield: Lowest Yield Since the 1960's

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After five years of outperformance and despite the fact that overseas economies were expected to fare better than that of the US, foreign stock markets did not provide any buffer against US equity declines. As fears spread around the world about the effects of a US recession and as ramifications of the credit crunch surfaced in Europe and Asia, there was no region of the world that was immune to equity market volatility and decline. China and India, two countries that had been among last year's high fliers, were among this quarter's biggest losers, each falling over 20%, while Japan's benchmark average was down 18%. For the quarter, the MSCI-EAFE Index fell 8.9% while the MSCI-Emerging Markets Index fell 11.0%. In local currency terms, most foreign markets performed worse than these benchmark returns but US investors continued to benefit from the unabated decline in the US dollar. The dollar sunk to new lows versus the Euro and to its lowest level against the Japanese yen since 1995.

BOND MARKET

Usually a softening economy is accompanied by falling interest rates, but in the environment of the worst credit crunch in decades, only US Treasury securities fell in yield while rates on any securities that carried risk generally rose. While the Federal Reserve dramatically cut the Federal Funds rate a full 2% to 2.25% during the quarter, the benchmark 10-year US Treasury note yield declined from 4.03% to 3.52% over the three months. Reflecting the higher risk premiums in the market, the yield spread between investment grade corporate bonds over comparable Treasuries widened by a full 1% while the spread between high yield junk bonds and Treasuries widened by 2% even though default rates remained low to date. Issuance of new junk debt declined dramatically. Since settling at 3.5% at the end of 2006, the yield advantage of high yield over Treasury bonds has widened 4.5% to 8%. Because Treasuries form a substantial part

of the Index, the Lehman Brothers Aggregate Index registered a positive 2.2% for the quarter. But, as noted, performance was directly correlated with quality. Junk bonds registered losses of about 3%.

OTHER ASSET CLASSES

Real estate provided good diversification benefits during the first quarter. Equity REITS lost 15.7% during 2007, but stabilized to post a positive return of 1.4%. Not only is commercial real estate, although weakening, holding up much better than residential real estate during the current downturn but apartments, one of the major segments of the REIT market, are apparently benefiting from people who are moving into rental units out of homes they can no longer afford. As for private real estate investment, first quarter results for the NCREIF Index, which had a positive return of 15.8% for 2007, are not yet available but, when they are, may not reflect the full extent of market weakness since values in the index only change upon revaluations or transactions on underlying properties.

Benchmark returns from alternative investments are not yet available but it is unlikely that the sector provided significant respite from the losses suffered in the public markets. There were only five venture-backed Initial Public Offerings during the quarter, the lowest number in almost five years. The number of venture-backed companies involved in either mergers or acquisitions was the lowest of this decade. Conditions in the credit markets were making leveraged buyouts increasingly difficult and time will tell to what extent general partners will mark down the value of existing private equity holdings.

The hedge fund industry was thankful to have avoided a rash of major blowups during the recent credit market turmoil. Many highly leveraged funds were reducing the extent of their borrowings and many funds were closely re-evaluating the strength of the various

counterparties that they deal with, including their prime brokers. As always, returns from hedge funds will be strategy-specific and manager-specific but composite returns for the quarter were in the range of -2% and -4%, a disappointment for investors seeking absolute returns but still better than the stock market's losses of almost 10%. Certain relative value strategies and long/short might benefit from the increased level of equity market volatility but event-driven strategies like merger arbitrage may face pressure as a result of the fall-off in deals.

CONCLUSION

While the past quarter was a painful one for most investors, it did offer some valuable lessons. First, it reminded us of the basic fact that equities are among the most risky of all asset classes. Second, in times of equity market volatility, investment in other asset classes — not only in fixed income but also in nontraditional asset classes — will likely soften the blow. We've previously written about some of the many lessons to be learned from the ongoing credit crunch, starting with the importance of carefully assessing risk premiums before making an investment or lending money. Investors must be careful not only in choosing whom to lend to but also whom to borrow from. Investing is never easy but in times like these it can be particularly challenging. Those who try to time the tops and bottoms of volatile markets will probably not fare as well as those who maintain disciplined and well diversified investment programs, who work hard to select top-tier managers, and who closely monitor every aspect of their investment program.

TOTAL RETURNS | FIRST QUARTER, 2008

INDEX	FIRST QUARTER 2008	TRAILING TWELVE MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 7.0%	+ 1.60%
Standard & Poor's 500 (Large Cap)	- 9.45%	- 5.08%
NASDAQ Composite	-14.1%	- 5.90%
Wilshire 5000 (Broad Market)	- 9.52%	- 5.76%
Standard & Poor's Mid-Cap 400	- 8.85%	- 6.97%
Russell 2000 (Small Cap.)	- 9.90%	- 13.00%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	- 10.18%	- 0.75%
Russell 1000 (Large Cap) Value	- 8.72%	- 9.99%
Russell Midcap Growth	- 10.95%	- 4.55%
Russell Midcap Value	- 8.64%	- 14.12%
Russell 2000 Growth	- 12.83%	- 8.94%
Russell 2000 Value	- 6.53%	- 16.88%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 8.91%	- 2.70%
M.S.C.I. - Emerging Markets	- 10.99%	+ 21.33%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 2.17%	+ 7.60%
Merrill Lynch High Yield Index	- 2.98%	- 3.46%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 1.40%	- 17.37%
	(Q4)	(Trailing 12 months)
HEDGE FUNDS		
Hedge Fund Research Fund of Funds	- 3.85%	+ 2.44%